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PACIFIC TELESIS
Group-Washington

ORIGINAL
FILE

October 13, 1992

Donna R. Searcy
Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Ms Searcy:

Re: *CC Docket No. 92-133 - Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "*Reply Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

J. A. Goddard Riley/WFA

Enclosures

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes	)	CC Docket No. 92-133

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell ("the Pacific Companies") submit their reply comments in response to comments on the reformation of the Part 65 rules proposed by the Notice of Proposed Rulemaking in the above-captioned docket.[1]

Responses to the Commission's proposals attest to an industry overwhelmingly unified in support of a unitary rate of return, a semi-automatic trigger mechanism, the use of Form M as a source of data for capital structure and cost of debt determination, flexibility in the choice of methodologies to determine the cost of capital and the acceptability of the tariff review and complaint processes to enforce rate of return prescriptions. Only a few filings varied from the predominant

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[1] Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, CC Docket No. 92-133, Notice of Proposed Rulemaking and Order, released July 13, 1992 ("NPRM").

views of the other thirty-six commenters, who are primarily rate of return regulated local exchange companies ("LECs"). And, even among the variant commenters, there are elements of agreement. For example, MCI, one of the three non-LEC commenters, agrees that a semi-automatic rather than an automatic trigger would be preferable[2] and that the Commission should not codify the use of any specific method to estimate the cost of capital.[3] In view of this decisive unanimity, the Pacific Companies reiterate their concurrence with the majority positions and limit their specific comments herein to reply to several issues raised by the few dissenting commenters.

I. Discussion Of Price Cap Sharing Mechanisms Should Be Rejected In This Proceeding.

Two commenters relate the rate of return represcription to the sharing mechanism for price cap LECs and either impliedly or expressly advocate a change to the price cap sharing mechanism because of a Part 65 represcription. MCI limits its remarks to precautionary statements advising the Commission that its action in this docket may affect price cap regulation and therefore may be more significant than initially assessed.[4] However, GSA argues vigorously that the price cap lower adjustment mark and

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[2] Comments of MCI Telecommunications Corporation, September 11, 1992, ("MCI"), p. 4.

[3] Id., p. 24.

[4] Id., pp. 2-4.

sharing zones must be automatically adjusted with a change in the authorized rate of return.[5]

The Commission should disregard any suggestion to consider price cap mechanisms in this proceeding which deals with rate of return regulation. This is not the proper forum. Price cap regulation is not the focus of this rulemaking. Considerations about the applicability of this proceeding's outcomes to price cap regulation are off the mark and untimely.

The price cap framework provides for a stable sharing mechanism intentionally unchanged during the initial period. That is clear from the Commission's statement: "To provide a fair evaluation of the program, it is also important that the initial period before periodic review and the possibility of major adjustments be long enough for incentives to operate."[6] The Commission reiterated that position. "In order to provide a reasonable period in which to review the operation of the price cap plan, we anticipate continuing the earnings levels in the backstop at the levels adopted here for at least the initial four year price cap period."[7] Moreover, the Price Cap Order structures sharing around the specific rate of 11.25%. The order

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[5] Comments of the General Services Administration, dated September 11, 1992, ("GSA"), pp. 2-6.

[6] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990)("Price Cap Order"), para. 386.

[7] Id., para. 129, emphasis supplied.

does not base sharing on whatever rate of return may be prescribed during the price cap period.

GSA attempts to overcome the Commission's crystal clear position by interpreting the Price Cap Order "as intending that the symmetrical zone around the authorized return would remain 100 basis points for the duration of the trial period".[8] That flies in the face of the Order's literal language and logic and is unsupported by any evidence.

On the other hand, the Price Cap Order clearly contemplates that the sharing mechanism itself is likely to be an important topic in the review of the price cap model at the end of the first price cap period. The Commission said, "The performance review should provide sufficient information to allow the Commission to reevaluate the need for lower end adjustment and sharing mechanisms."[9] GSA comments should be reserved for the price cap review proceeding.

In light of these clear statements, there is no reason to believe that the Commission contemplated any change to the sharing benchmark during the initial four year price cap period. GSA's unrealistic interpretation must be rejected.

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[8] GSA, p. 5.

[9] Price Cap Order, para. 394.

II. A Streamlined Part 65 Protects The Interests Of The Participants In The Rate Of Return Represcription.

The Pacific Companies support the streamlining of Part 65 procedure consistent with the Communications Act. However, mere notice and comment is not sufficient. There must be a "full opportunity for hearing" as required by Section 205 of the Communications Act. The process of notice and hearing are not sufficient to provide for that full opportunity. The United States Telephone Association ("USTA") fully briefed the necessity of providing more than mere notice and comment when there are contested factual issues in ratemaking.[10] MCI admits that "a ROR represcription proceeding is a much more focused, fact-intensive and adversarial proceeding than the typical notice and comment rulemaking."[11] The Part 65 hearing process, significantly streamlined as set out by USTA, will protect the interests of the parties and provide the Commission with complete information necessary to make a proper determination.

III. MCI's Recommendation For Classic DCF Must Be Rejected.

The industry unequivocally supports the need for flexibility in the determination of the cost of capital and urges that the Commission not adopt any particular methodology. Any methodology should be available to estimate the cost of equity.

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[10] Comments of the United States Telephone Association, September 11, 1992, pp. 7-21.

[11] MCI, p. viii, emphasis added.

And, one methodology should not be afforded greater significance or weight than another. Parties should also be able to object to or support the use of any methodology.

MCI supports this position.[12] Yet, while agreeing that "the Commission should not adopt 'presumptive methodologies' or in any other way restrict its discretion to accord weight to one or more cost of equity methodologies at the time it represcribes the ROR [rate of return]",[13] MCI "agrees that the 'classic' DCF should continue to be applied in future represcription proceedings, and in the same way as it was applied in the 1990 Represcription Order, for the reasons stated therein."[14] This recommendation that the "classic" DCF method should continue to be applied is inconsistent with its stated position endorsing the availability of any methodology to estimate the cost of equity.

While the use of the constant growth rate DCF model that MCI refers to as the "classic" model may have applications in future proceedings, that applicability will depend on the assumptions employed and the group of comparable firms selected for analysis. Moreover, MCI's recommendation that the "classic" DCF should continue to be applied "and in the same way it was applied in the 1990 Represcription Order" seeks to de facto codify a methodology and set of assumptions that were

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12 MCI, pp. v, 4, 23-25.

13 Id., p. 24.

14 Id., p. 25.

controversial in that proceeding, were found by many interested parties to produce inappropriate results and which may be inappropriate for future represcriptions. In line with MCI's overall position that the Commission not adopt any particular methodology nor adopt "presumptive methodologies", the Commission must reject MCI's proposal to codify de facto the "classic" DCF model.

IV. USTA's Proposed Trigger Is Superior To Other Suggestions.

The Pacific Companies support the USTA proposal that would commence a represcription when there has been a 150 basis point shift in the six month moving average of Aa Public Utility Bond yields as measured by Moody's Bond Record when the shift lasts for six consecutive months. MCI, on the other hand, while agreeing with the LECs that a semi-automatic trigger should be adopted, appears to suggest using long-term interest rates and the Regional Holding Companies' ("RHCs") Discounted Cash Flow cost of equity estimates as the trigger.[15] GSA concludes that the 10-year United States Treasury security yield would be most suitable.[16]

The Pacific Companies do not disagree with MCI that long-term interest rates can be an acceptable indication of significant change to the capital market. However, MCI's

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[15] MCI, p. 5.

[16] GSA, p. 8.

suggestion that a represcription in which the cost of equity is determined should be initiated by first examining the cost of equity is undesirable for its circularity and would be unproductive as well. A trigger mechanism need not attempt to measure the cost of capital for the LECs. It should be a broad indication of the capital market that signals the appropriateness of initiating a review of the cost of capital for local exchange carriers. A trigger should be simple, observable and objective. Long term interest rates meet these criteria. It is nonsensical to first determine a cost of equity in order to trigger a proceeding in which the the Commission will be required to determine the cost of equity as one component of the rate of return analysis.

MCI's suggestion that the Discounted Cash Flow ("DCF") methodology should be used to determine cost of equity estimates is also unproductive because it introduces an element of potentially great controversy to the trigger mechanism. The notion that DCF is more accurate than other methods to determine the cost of equity was vigorously challenged in the last represcription. Moreover, the Pacific Companies absolutely disagree with the proposal that the cost of equity estimates for the RHCs should be afforded presumptive weight as an indicator of a change in the cost of equity for the BOCs. Neither the RHCs' capital structure nor their cost of equity should be taken to automatically apply to the BOCs. BOCs have their own capital structures including debt issued by the BOCs (not the RHCs). Debt levels, costs, terms and conditions are based on operational

requirements and investors' assessment of the BOCs themselves -- not their parents.

GSA's suggested 10-year Treasury security yield should be rejected as less desirable than the USTA proposal. The trigger should emulate the indicia of ownership that is part of investors' expectations -- that the right (and risk) of ownership will be permanent. Shareholder valuation of a company's equity offering is predicated on the long term, permanent nature of ownership investment, not with an identifiable termination point. While not a perfect surrogate for the permanence of equity investment, USTA's proposal of utilizing Aa Public Utility Bond yields as part of a trigger mechanism more closely approximates investors' expectations of long term investment.[17] A 10-year note yield is not as desirable as a longer term measurement for the purposes here and should be rejected.

V. Conclusion.

For the reasons provided above, the Commission must reject recommendations that are clearly contrary to the overwhelmingly unified responses of the industry. The record in this proceeding provides the Commission with clear direction on the reformation of the rate of return represcription and

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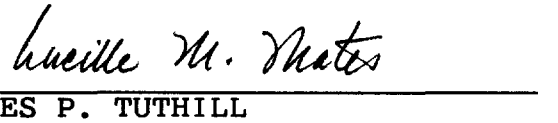
[17] For example, California has adopted a rate of return review trigger mechanism with a 250 basis point spread around a 30-year Treasury Bond yield benchmark for its state rate of return represcription.

enforcement processes. Pacific Bell urges the Commission to adopt the highly endorsed procedures proposed by USTA. A semi-automatic trigger should begin the process. There must be opportunity for thorough presentation of all the relevant evidence without the built-in redundancy of the current process. The revised rules should also provide for flexibility so that all the data available for determining the rate of return can be developed, including that needed to estimate the cost of capital. This will meet the Commission's goal of reducing unnecessary regulatory burdens on the local exchange carriers and the Commission.

Respectfully submitted,

PACIFIC BELL
NEVADA BELL



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Date: October 13, 1992

CERTIFICATE OF SERVICE

I, S. B. Ard, do hereby certify that a copy of the foregoing "REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL" in CC Dkt. 92-133, was served on the following parties of the attached Service List on October 13, 1992 by hand or by first class United States mail, postage prepaid.

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